



*Report to the Washington State, Office of
Insurance Commissioner on Tax Matters in
Connection with the Proposed Conversion
Premera*

Report Addendum

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Orders of the Washington State Commissioner of
Insurance**

February 27, 2004

*Prepared for the Washington Office of the Insurance
Commissioner*

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OVERVIEW

This report addendum is prepared as an update to our report dated October 27, 2003 titled "Report to the Washington State, Office of Insurance Commissioner on Tax Matters in Connection with the Proposed Conversion of Premera," (the Tax Report). Following completion of that report and the reports of other experts engaged by the State of Washington, Premera Blue Cross sought and received approval to amend its Form A application to the Washington Office of the Insurance Commissioner to convert from a non-profit health services contractor to a for profit publicly traded health insurer,¹ originally filed September 17, 2002. The revised Form A was filed on February 5, 2004. The revisions to the Form A were made to address a number of key concerns raised by PricewaterhouseCoopers and others in the reports filed on October 27, 2003. The modifications were discussed in a series of meetings; while many of the specific suggestions of the consulting team are reflected in the revised Form A and accompanying documents, a number of recommendations were not adopted by Premera.

Specific to the Tax Report meetings were held to discuss changes that, if made, would eliminate the necessity for certain of our recommendations to the Washington OIC as discussed throughout the Tax Report and as principally described in the OIC Approval Conditions for Consideration section of the Tax Report. This addendum outlines the results of these discussions.

1) Tax Indemnification Agreement

The Tax Report indicates that PwC has significant concern as to whether the risks passed on to the Foundation Shareholder(s) as a result of the Indemnification Agreement are appropriate, and suggests that the OIC consider disapproval of the Indemnification Agreement.

Resolution: Premera has eliminated the Indemnification Agreement from the Plan of Conversion Documents.

2) Timely receipt of final tax opinions acceptable to the OIC

It was recommended that the Washington OIC condition its approval of the Conversion Transaction on the receipt of final tax opinions in a form acceptable to the OIC. It is the OIC's preference that Premera issue final tax opinions prior to the scheduled Hearing Date to allow adequate review time by the OIC and its advisors. Such opinions would subsequently be brought down to the Closing Date of the Conversion Transaction.

¹ Form A: Statement Regarding the Acquisition of Control of a Domestic Health Carrier and a Domestic Insurer. Direct or Indirect Affiliates of Premera by New Premera Corp. September 17, 2002. This was also filed with the Alaska Division of Insurance and the Oregon Insurance Division.
<http://www.insurance.wa.gov/special/premera/filing.asp>

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Resolution: Premera has made certain modifications to the Plan of Conversion document at Article IV, Section 4.3(a)(xiii). These modifications require that Premera provide tax opinions to the Washington OIC and the Alaska Division of Insurance at least five (5) business days prior to the Form A Hearing Date that in form and substance is substantially the same as the tax opinions received by Premera from its special counsel dated as of the Closing Date.

PwC believes that the modifications to the Plan of Conversion as discussed above are sufficient to allow for adequate review and consideration of the tax opinions in advance of the Form A Hearing Date.

3) Tax Opinion Regarding a “Material Change in Structure”

It was recommended that the Washington OIC condition its approval of the Conversion Transaction on the timely receipt of a final tax opinion on the ability of Premera to avoid a “material change” under Section 833 of the Code.²

In subsequent discussions with Premera management and its advisors, Premera has requested that PwC reconsider whether obtaining a tax opinion with respect to the “material change in structure” should be a condition of approval. Premera has indicated that it is still their intention to obtain a tax opinion from Ernst & Young LLP that the Conversion Transaction will “more likely than not” fail to constitute a “material change in structure or operations”. Premera is concerned, however, that certain tax developments could occur prior to the Hearing Date or the Conversion Date that would preclude Ernst & Young LLP from issuing this opinion.

Resolution: PwC has further considered this matter and has concluded that a tax opinion at the “more likely than not” level of assurance as contemplated above does not materially reduce the uncertainty associated with this issue. It would therefore be acceptable to remove this tax opinion as a condition of approval. In the absence of the tax opinion, however, PwC has recommended to the advisors of both the Washington OIC and Alaska Division of Insurance that their analyses should assume that the special tax benefits under Section 833(b) of the Code are lost as a result of the Conversion Transaction.

4) Washington State Tax Matters

It was recommended that the Washington OIC condition its approval of the Conversion Transaction on the receipt of a satisfactory favorable ruling from the state of Washington on the tax treatment of the Conversion Transaction.

Resolution: Premera has made certain modifications to the Plan of Conversion document at Article IV, Section 4.3(a)(xviii). These modifications require that Premera shall have obtained

² PwC also recommended conditioning approval of the Conversion Transaction on the receipt of final tax opinions acceptable to the Washington OIC on the tax-free treatment of the Conversion Transaction, and the ability of Premera to avoid an ownership change under Section 382 of the Code. The Plan of Conversion, in its current form, requires Premera to obtain tax opinions acceptable to the Washington OIC and Alaska Division of Insurance on these matters.

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one or more tax rulings from the Washington Department of Revenue holding that there shall be no imposition of the Washington sales, use, business and occupation, or real estate transfer taxes to the transfers of assets pursuant to the Plan of Conversion, which would result in a material tax amount to the parties of the Plan of Conversion. This change eliminates the need for the Washington OIC to condition its approval of the Conversion Transaction on the receipt of a satisfactory favorable ruling from the state of Washington.

5) Amendments to the Plan of Conversion

It was recommended that Premera eliminate the provisions set forth at Article IV, Section 4.3(a)(xiv) and (xv) of the original Plan of Conversion document.

Resolution: These sections of the Plan of Conversion were eliminated in the revised Plan of Conversion.

6) Level of Opinion with Respect to Tax-Free Treatment of Conversion Transaction

In connection with the review of the tax consequences of the Conversion Transaction, the Washington OIC and its advisors were provided with a “draft” tax opinion from Ernst & Young LLP. The “draft” tax opinion provides, in part, that the Conversion Transaction “will” constitute one or more reorganizations within the meaning of Section 368(a) of the Code and the Formation of PBC – Alaska “will” constitute a transaction to which Section 351 applies. Further, the opinion indicates that no gain or loss “will” be recognized by the Foundation, Premera, New Premera, PBC, New PBC, PBC – Alaska, WAGS, Quality Solutions, New Quality Solutions, LifeWise Washington and New LifeWise Washington as a result of the Conversion Transaction.

In the Tax Report, PwC indicates that, while it expresses no opinion on the tax-free treatment of the Conversion Transaction, it does not find the “draft” tax opinion issued by Ernst & Young LLP to be unreasonable. Further, the Tax Report indicates that, while a favorable private letter ruling would provide certainty with respect to this matter, the “will” tax opinion provides a relatively high level of assurance. As such, PwC does not believe that it is unreasonable for Premera to rely on a tax opinion of this nature for purposes of obtaining comfort with respect to the issue.

While the “draft” tax opinion indicates a “will” level of opinion with respect to the issues described above, the previous draft Plan of Conversion indicated that Premera would obtain a “should” level opinion with respect to these tax matters. A “will” level of opinion provides a higher degree of certainty with respect to a particular tax matter than does a “should” level opinion. The Washington OIC and its advisors believe that the Plan of Conversion should provide for a “will” level of opinion consistent with the “draft” tax opinion. As such, the Washington OIC and its advisors previously recommended that Premera make certain modifications to the Plan of Conversion at Article IV, Section 4.3(a)(xiii) relating to Tax Opinions to conform such to the language contained in the “draft” tax opinion.

Premera, in the revised Plan of Conversion, did not adopt these modifications. While the Washington OIC and its advisors expect the tax opinion, which is to be received no later than 5

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days prior to the Hearing Date, to be in substantially the same form as the “draft” tax opinions described above, the Plan of Conversion only requires a “should” level of opinion.

Resolution: If a “should” level of opinion is ultimately obtained by Premera with respect to the tax-free nature of the Conversion Transaction, PwC will recommend that the Washington OIC consider whether the lower level of assurance related to this level of opinion is appropriate given the significance of the adverse tax consequences that would arise if the Conversion Transaction is ultimately determined to be a taxable transaction.

7) Review and Analysis of the Tax Issues Associated with the Foundation Shareholder(s)/Charitable Organization(s)

A separate addendum to the Tax Report will address the modification to the Plan of Conversion Documents as they relate to these tax matters.